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Mr. Stuart Drown
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Dear Mr. Drown:

Thank you for the opportunity to testify before the Little Hoover Commission at the hearing regarding the governance structure of the California Stem Cell Research and Cures Act, the membership of the Independent Citizens Oversight Committee (ICOC), and the California Institute of Regenerative Medicine (CIRM). In lieu of written testimony, I have submitted an article that I have published on the governance of nonprofits.

The article that I have submitted highlights a problem that many nonprofits face: a board that is too large, too disparate in the interests and skills of its members, and too unfocused to perform a governance role effectively. Because I am not familiar with the details of how the ICOC and CIRM operate, I have no view on the extent to which those problems are present. I am hopeful, however, that I can provide the Commission with a basis for thinking about the issue as it continues its study.

Beyond what I discuss in my article, I will testify on the proper role for a board or oversight body in relation to the executive staff of an organization, and on potential conflicts of interest and mechanisms for addressing potential conflicts when they arise.

I look forward to speaking with you and the Commission.

Sincerely,

Michael Klausner



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STANFORD SOCIAL INNOVATION *review*

Failing to Govern?
The disconnect between theory and reality
in nonprofit boards, and how to fix it

By Michael Klausner & Jonathan Small

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FAILING TO

The disconnect between theory and reality



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ast September, the board of the Beard Foundation took a lashing when the *New York Times* broke the story of the foundation's inability to account for hundreds of thousands of dollars in annual revenue. The prestigious culinary institute, founded by Julia Child, had \$4.7 million in revenues in 2003, and gave out only \$29,500 in scholarships. "Whatever they [the board] did or didn't know and did or didn't do themselves," said Corby Kum-

mer, a prominent food writer, to the *New York Times* on Dec. 15, "it happened on their watch, and they have to offer to go." In December, after the president Leonard F. Pickell Jr. was indicted for stealing from the nonprofit to cover personal debts, the entire board tendered their resignations.

In recent years, news reports like this one increasingly suggest that too many directors of nonprofit organizations are failing to govern. And thus

PHOTOGRAPH BY S. WEIKIN/MASTERFILE

GOVERN?

in nonprofit boards, and how to fix it

by MICHAEL KLAUSNER AND JONATHAN SMALL



they are failing to fulfill the fiduciary duty of care that the law imposes on them. Commentators suggest that each and every director should work harder and more effectively at governance. Recent legislative proposals indicate that some lawmakers agree.¹

In our view, the commentators are right on the facts – many directors are not governing – but dead wrong on the solution. We believe the answer for many nonprofits is exactly the opposite: All direc-

tors *should not* be asked or expected to govern. Nonprofit organizations and their boards vary, but for many the expectation that all directors will govern – an expectation that stems from a misplaced analogy with for-profit boards – is inconsistent with the inherent nature of the nonprofit board, inconsistent with effective governance by the board as a whole, and inconsistent with the board being effective in other equally important functions.

In contrast to their counterparts on for-profit boards, directors of nonprofit organizations are called upon to perform several functions. Some directors give or raise funds; others provide special expertise; others maintain ties to an important community; others are there because their stature serves as a signal that the organization does good work. And some – perhaps just a few – govern.² All of these functions are important, and the reality is that there is typically a division of labor on a board, a division that reflects the varied interests and abilities of those who choose to join a board.

Rather than trying to fit the square peg of the for-profit board into the round hole of the nonprofit organization, nonprofits should structure their boards to reflect the reality that some board members perform governance functions, and some do not – and that that's OK. Directors who do not govern generally perform other functions that are just as important to the organization. There is no reason to pretend that all directors actually govern, nor is there reason to ask or expect them to. And there certainly is good reason to keep them on the board so that they can contribute in these other ways.

We propose a “Bifurcated Board” structure in which organizations designate some board members as “governors,” and relieve other board members of all governance responsibilities. This specialization and clarification of roles would improve governance without sacrificing the valuable contributions that board members make to the organization they serve.

Depending on where a nonprofit organization is incorporated, this approach could be adopted by some organizations under existing law. For others, state (but not federal) nonprofit corporation laws would have to be amended in the way that we outline below.

What is Governance?

The legal source of the nonprofit board's governance obligation lies in state nonprofit corporation statutes, which typically provide that a nonprofit corporation shall be “managed under the direction of” its board of directors.³ What this means in practice is that the board hires, fires, evaluates, and sets compensation for the executive director. The board also reviews and

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gives input on the organization's strategic plan, oversees the organization's budget and programs, and reviews the organization's financial statements.

A typical board meets between four and 12 times a year, and depending on the business to be conducted, diligent preparation for a meeting can require several hours of work. In addition to exercising oversight as a single body, boards often govern through committees as well. Board committees typically delve more deeply into issues than does the board as a whole, and they recommend actions to the board. The most important and most active of these committees is typically the executive committee. The executive committee may get closely involved in the organization's operation on an ongoing basis, especially if the board as a whole meets infrequently.

Nonprofit Boards Do Much More

While the board's legally mandated governance function is important, other functions have evolved for nonprofit boards that are not legally required. These functions can be at least as important as the board's governance function. Most notably, nonprofit boards commonly serve a fundraising role, a role that, for many organizations, is a sine qua non of their existence. Some board members make large contributions; others use their contacts to raise funds.⁴ For many organizations, this role is explicit. For example, a leading New York literacy organization asks its board members to “give and get” amounts that are “just beyond their comfort levels.” Another major New York civic organization specifically asks each board member to give or get \$10,000 each year.

For some nonprofits, especially cultural organizations, funds raised by board members make up a high percentage of donated funds. For instance, a large metropolitan museum currently engaged in a major capital campaign reports that board members' gifts accounted for 68 percent of campaign donations, which now stand at over \$700 million. Of the organization's 42 board members, 37 gave over \$5 million. These figures do not include funds that board members raised from others. Other types of nonprofits also rely heavily on their boards for fundraising. For instance, a leading pro bono legal services organization in New York reported that for the fiscal year ended in 2004, its 27 board members raised about \$350,000 out of contributions totaling approximately \$1 million. Board members of this organization contributed an additional 4 percent of that total themselves. A large New York educational institution that just ended a \$1.1 billion campaign attributes approximately 37 percent of its contributions to fundraising by board members.⁵ Consistent with these examples, Francie Ostrower reports in her study of why the wealthy give that 43.4 percent of donors' largest gifts went to organizations where the donor was a board member.⁶

Board members also provide valuable services to their organizations. Often these services are administrative. Lawyers on

Big Boards, Big Names

ORGANIZATION	BOARD SIZE	PROMINENT MEMBERS
Museum of Modern Art	58	Anna Deveare Smith – Playwright; Michael Ovitz – Former President, Disney
Tech Museum of Innovation	52	Steve Young – Former quarterback, San Francisco 49ers
San Francisco Symphony	80	Gordon P. Getty – Philanthropist; Ray Dolby – Inventor, Chairman of Dolby Labs
Alan Guttmacher Institute	40	Former Surgeon General Joycelyn Elders
Educational Broadcasting Corp.	90	Wynton Marsalis – Musician; Oscar de la Renta – Fashion Designer; Walter Cronkite – Journalist

boards commonly provide formal or informal legal advice; public relations professionals help shape the organization's message for either fundraising or mission-related purposes; real estate experts help with the acquisition or disposition of real estate; and accountants give informal advice regarding financial reporting and oversight (though they cannot replace an outside auditor). Other board members provide services more directly related to the organization's mission.⁷ An environmental scientist, for example, on the board of an environmental organization may provide scientific advice; or an education expert on the board of an educational organization may provide insight on educational matters. The Brearley School, a prominent New York City day school, for example, traditionally enhances the substantive expertise of the board by including in its membership one or more heads of comparable schools.

Board members also serve as goodwill ambassadors to the constituencies that the organization serves or the community in which the organization operates.⁸ They advise the organization on how best to deliver services to fulfill its mission, and how best to be a good member of the community. They inform the community and relevant constituencies of the services the organization can provide. The Citizens Advice Bureau, a large community-based settlement house in the Bronx, is typical. It has several board members with close ties to the community. One, for example, is a longtime Bronx resident with over 40 years of community involvement who serves on the local community board, heads a small Bronx-based social services agency, and is involved with many local organizations.

Another important nongoverning function some board members provide is simply lending their name to the cause. By virtue of their presence alone, these "big name" board members – a movie star, sports star, or former senator, for example – can attract funds, employees, volunteers, press attention, and other

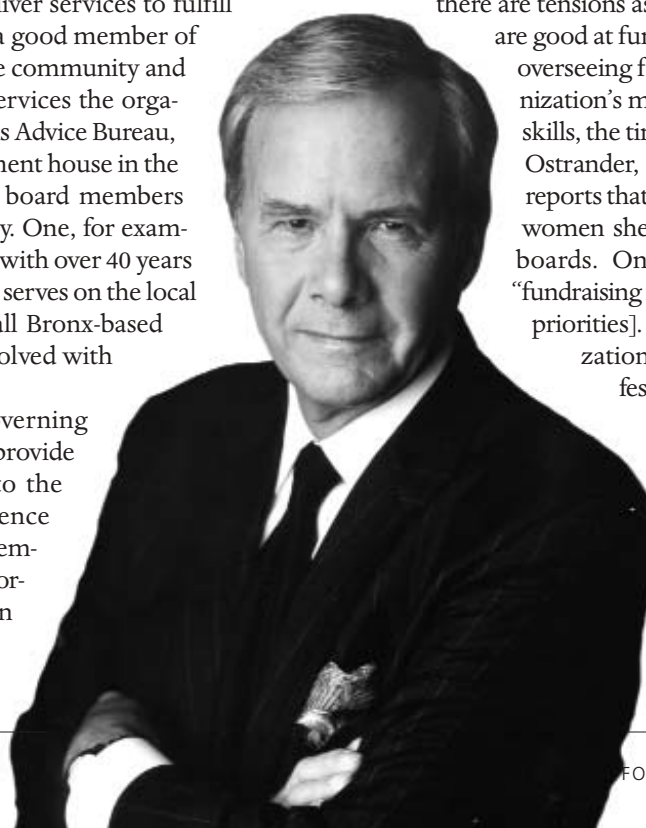
intangibles that can help an organization pursue its mission. Gwyneth Paltrow's presence on the board of the Robin Hood Foundation is an example of such star power, as is that of Tom Brokaw as a board member of the International Rescue Committee. This type of director can be valuable to an organization regardless of whether they attend a board meeting.⁹

A board member's service in any of these roles is not inconsistent with his or her involvement in an organization's governance as well. There are certainly many cases of board members raising a lot of money, providing important services, or lending their prominence to an organization, and governing as well. Our point is simply that this need not be the case.

Do All Directors Need to Govern?

While there may be virtues in having each director serve the board's governance function in addition to other board functions, there are tensions as well. For example, individuals who are good at fundraising may or may not be good at overseeing finances or other aspects of the organization's management. They may not have the skills, the time, or the interest. Sociologist Susan Ostrander, in her study of upper-class women, reports that "fundraising is the main task" of the women she interviewed who sat on nonprofit boards. One woman in her study told her "fundraising is absolutely at the top [of the board's priorities]. ... [It is] the main thing that organizations want from you."¹⁰ Another confessed, "I don't bring a lot of know-how, but I'm good at fundraising and I like it." They will not discover the time, the skills, or the inclination

Tom Brokaw sits on the board of the International Rescue Committee. Such celebrities can be valuable regardless of whether they attend meetings.



PHOTOGRAPH COURTESY OF NBC

There is no reason to pretend that all directors actually govern, nor is there reason to ask or expect them to.

to govern simply because they are told to. In all likelihood, they will either continue to govern poorly or not govern at all. Or perhaps worse, they will respond to the call for better governance by declining to serve on nonprofit boards. In that case, the other ways that these would-be board members contribute will be lost to the nonprofit sector.

A second problem in asking all board members to govern is that there are often too many people on the board to govern effectively. Nonprofit boards commonly include well over 30 members.¹¹ The San Francisco Symphony, for example, has an 80-member board; the Tech Museum of Innovation in San Jose, Calif., has 52; and the Legal Aid Society of New York has 51. Many nonprofits need large boards because the nongover-

nance functions of the board – fundraising and public relations in particular – are often enhanced by having a large board. In fundraising, more directors mean more funds, at least up to a point. If there are many constituencies with which the organization needs to work, more directors can also promote better integration with relevant communities. And attracting more “big names” may help the nonprofit attract both donors and publicity for its work.

Yet for purposes of governance, large boards often do a bad job. Among for-profit firms, the median board size is 12 to 13 members. And research has shown that boards smaller than that govern more effectively.¹² This finding is not surprising. As a group gets larger, individual members are tempted to free ride

on the efforts of others. Why study the details of a proposed budget, for example, if 39 other board members, or at least some of them (hopefully), will?

For many organizations, having all directors govern is unrealistic and unwise. A board may well perform its governance and nongovernance functions best if only a fraction of its members govern. Specialization of labor may be efficient on a nonprofit board, just as it often is in other contexts.

Who Said All Nonprofit Directors Must Govern?

The premise that all board members will govern is grounded in state nonprofit corporation laws, which provide that a nonprofit corporation shall be managed “by,” or “under the direction of,” a board of directors. The laws further provide that directors have a fiduciary duty to the organization (though enforcement is lax). Nonprofit corporation statutes evolved from for-profit corporation statutes, and the governance duty assigned to nonprofit directors is similar to that assigned to for-profit directors.



The Tech Museum has 52 board members. Like many nonprofits, the large board is essential to raising money and providing outreach.

PHOTOGRAPH COURTESY OF THE TECH MUSEUM

This congruence is based, however, on the faulty premise that a nonprofit board is functionally similar to a for-profit board.

But the board of a for-profit corporation is quite different from a nonprofit board. The for-profit board's role is to govern the corporation in a manner that maximizes profits. While board members of some for-profits can be helpful in making introductions to potential investors, suppliers, or customers, it is clear that their primary role is governance. Consequently, board members of for-profit companies can be selected based solely on their business skills and experience, and board size can be based on efficiency in governance.¹³

The Bifurcated Board: Governing and Nongoverning Directors

Rather than mimic for-profit boards, nonprofits should structure their boards to reflect the reality that some board members govern and some do not. Of course, if all of a nonprofit's board members do govern, there is no need to do this, but especially for organizations with large boards, an explicit division of labor would not only recognize a reality that exists but also enhance governance without undermining the other functions nonprofit boards perform.

The ideal structure for a nonprofit is an explicitly Bifurcated Board: Some board members would be designated as "governing board members" and the rest as "nongoverning board members." Governing board members, who might organize themselves as the "Governors' Committee," would commit to governing. They would shoulder all the legal duties and responsibilities otherwise vested in the board, and relieve nongoverning board members of those duties and responsibilities. Although the nongoverning board members would have no governance obligations, they would continue to perform the other important functions for which they were put on the board. Any listing of the board members – on an organization's Web site, for instance – would identify those directors who are governors and state that they have taken on the legal duties and responsibilities of the board.

The objective of the Bifurcated Board structure is to make the governance role clear to the board members who assume governance responsibility and to the public, while also continuing to use the board for fundraising and other nongovernance functions. Under such a structure, everyone's role would be clear. An organization would ideally include specific obligations for governors in its articles or bylaws, such as required attendance at board meetings, committee membership obligations, and attendance at committee meetings. Governors who do not fulfill those obligations would be expected to resign as governors or have their governor status removed. They could, however, remain on the board as nongoverning members.

Aside from explicitly recognizing some board members as governors and some as nongovernors, little else would have to



The board of the San Francisco Symphony reads like an excerpt out of the Social Register.

change. Among the governors, board committees would be unaffected. There would typically be an executive committee, and often audit, finance, compensation, and nominating committees. Nongoverning board members would also do what they currently do. They would give funds, get funds, advise the executive director and the rest of the board regarding issues on which they have expertise, and they would help the organization maintain relationships with important constituencies. Governing board members could perform those functions as well.

In creating this structure, a nonprofit would want to avoid making nongoverning directors feel like second-class citizens. Membership on the board should continue to be rewarding to these directors. This need not be difficult. Directors themselves could choose whether to be governing or nongoverning board members. If the number of directors who want to be governors is larger than the number that would allow for effective governance, board members could rotate in this role. They could also attend board and committee meetings at which governance matters are discussed as nonvoting participants.

The designation of directors as governing and nongoverning board members also need not be permanent. Board members could choose to govern one year and not govern another, depending on their interest and availability. Designations could be made each year at an annual meeting of the board as a whole or by the current governors according to procedures and criteria specified in the organization's articles or bylaws.

There are two alternatives to a Bifurcated Board that a nonprofit could also consider – placing all nongovernors on an advisory board, or delegating all governance to an executive com-

Why Do People Join Boards?

Presumably, all directors want to promote the organization's mission – by writing large checks, getting others to write checks, performing services, providing strategic ideas, lending their prestige, or governing. Helping a nonprofit organization in these ways can provide meaning in one's life.

But there are other motivations. Board membership can provide social or business contacts.¹ And it can validate or confer social status.² In sociologist Francie Ostrower's study of why the wealthy give, one man explained: "I am a trustee of a hospital. You have to be a trustee of a hospital if you're wealthy. It's required. ... But I know nothing about hospitals."³ Another simply stated: "Social profile. A new forum of making social connections."⁴ One board member told anthropologist Teresa Odendahl: "There is a certain amount of ego satisfaction in this. ... It is not only because you are such a

public spirit. It is partly because that is the price you pay if you want to be a big shot – if you want to be known as someone who is active, if you want a certain amount of credit in the community."⁵ Yet another summed up the benefit of his museum board membership by saying, "The entrées leading off that board are not to be believed."⁶

The board memberships of large arts organizations and museums often read like excerpts out of the *Social Register* or a *Who's Who* directory. The Tech Museum of Innovation in San Jose, Calif., for example, is brimming with venture capitalists and senior officers of high-tech companies – with a member of Congress and a former football star to boot. The Museum of Modern Art in New York and the San Francisco Symphony attract the same crowd from their respective cities.

Board seats commonly serve as a vehicle through which successful peo-

ple become involved in nonprofit organizations.⁷ For an organization to attract a major donor, it is common to offer a board seat. "Actually I was invited to join the board. Which I consider that some sort of involvement like that is essential to significant giving," one wealthy donor explained to Ostrower regarding her large donation.⁸

1 Bowen, W.G., *Inside the Boardroom* (New York: John Wiley & Sons, 1994); Ostrower, F. *Why the Wealthy Give: The Culture of Elite Philanthropy* (Princeton, NJ: Princeton University Press, 1995); Odendahl, T. *Charity Begins at Home: Generosity and Self-Interest Among the Philanthropic Elite* (New York: Basic Books, 1990).

2 DiMaggio, P. and Useem, M. "The Arts in Class Reproduction" in *Cultural and Economic Reproduction in Education*, ed. Apple, M.W. (London: Routledge & Kegan Paul, 1982): 181-201; Ostrander, S.A. *Women of the Upper Class* (Philadelphia: Temple University Press, 1984).

3 Ostrower, *Why the Wealthy Give*, p. 36.

4 Ostrower, *Why the Wealthy Give*, p.38.

5 Odendahl, *Charity Begins At Home*, p. 34.

6 Odendahl, *Charity Begins At Home*, p. 34.

7 Bowen, *Inside the Boardroom*; Ostrower, *Why the Wealthy Give*; Odendahl, *Charity Begins At Home: Generosity and Self-Interest Among the Philanthropic Elite*.

8 Ostrower, *Why the Wealthy Give*, p. 32.

mittee of the board. However, neither of these structures is ideal. The advisory board option is attractive, and entails no legal complications, but for a large "giver," a well-connected "getter," a "big name," or a busy community leader, a position on the advisory board may not cut it. The reality of the nonprofit sector is that a seat on "The Board" is seen as a quid pro quo for a significant contribution of cash or services.¹⁴

Delegating governance responsibility exclusively to an executive committee has some attraction because the executive committee is familiar under current board practice, but it too is problematic. In some states, the board retains substantial responsibility for matters delegated to the executive committee, and in states where a complete transfer of authority is permitted, the Bifurcated Board is more effective. If the executive committee were to assume the full role of the board, there could well be a need for a super-executive committee to assume the role of the current executive committee. In addition, many organizations would still need an audit committee, a finance committee, a compensation committee, and other committees

with governance responsibilities. These could be subcommittees of the executive committee, but at that point, it would be clear that a governing board is being created within the board, and the use of the label "executive committee" could actually be confusing.

State Legislation Needed

Nonprofits could adopt a Bifurcated Board in states where the Revised Model Nonprofit Corporation Act has been enacted. All they would need to do is amend their articles of incorporation or bylaws. The act provides that an organization's "articles may authorize a person or persons to exercise some or all of the powers which would otherwise be exercised by a board," and that to the extent this is done, the board is relieved of its legal duties and responsibilities.¹⁵ Under our proposal, the nonprofit's articles of incorporation would designate the governors – or the Governors' Committee – as the people exercising what would otherwise be the board's powers, and relieve the nongoverning

Why study the details of a proposed budget if 39 other board members, or at least some of them, will?

board members of those powers as well as the associated responsibilities and liability risk.

Other states currently do not allow a complete transfer of board duties that is necessary for the Bifurcated Board. They allow some delegation, but the full board retains some responsibility and potential liability. In California, for example, the board may delegate management responsibilities, but even if they do, the full board retains ultimate responsibility.”¹⁶ In our view, the laws in those states should be amended to allow for a Bifurcated Board.

In states that have not adopted the provision of the Revised Model Nonprofit Corporation Act allowing the transfer of the board’s responsibilities, legislation authorizing a Bifurcated Board should be adopted. Such legislation could follow the approach of the act – allowing a full transfer of board duties and responsibilities to any individuals – or it could be more specific in allowing an organization to bifurcate its board into governors and nongovernors and to vest governance authority in the governors. In our view, the latter is preferable.

The Bottom Line

Some nonprofit directors fail to fulfill their governance obligations. But unlike some commentators who have responded to this situation simply by exhorting board members to take their governance responsibilities more seriously, we propose a structural change. Those directors who choose not to govern should be relieved of those obligations, but so long as they perform other valuable functions that nonprofit boards traditionally perform, they should be retained as board members. The Bifurcated Board that we propose is not only consistent with the current reality of many nonprofit boards, but it also provides clarity about which board members will govern and which will not. This clarity will promote effective governance. In addition, it should improve the performance of nongovernance functions, allowing nongoverning directors to focus their time and energy on these important responsibilities. States that currently do not allow organizations to adopt a Bifurcated Board should amend their nonprofit corporation statutes to do so. □

The authors would like to thank Paul Reist for his invaluable assistance with this article.

1 Staff Discussion Draft of the Senate Finance Committee on proposals for reforms in the area of tax-exempt organizations (2004), proposing a maximum of 15 directors on a board.

2 Middleton, M. “Nonprofit Boards of Directors: Beyond the Governance Function,” in *The Nonprofit Sector: A Research Handbook*, ed. Walter W. Powell (New Haven, CT: Yale University Press, 1987): 160-192; Widmer, C. “Role Conflict, Role Ambiguity, and Role Overload on Boards of Directors of Nonprofit Human Service Organizations,” in *Nonprofit Boards of Directors: Analyses and Applications*, eds. Herman, R.D. and Van Til, J. (New Brunswick, NJ: Transaction, 1989): 139-151; and Miller, J. “The Board as Monitor of Organizational Activity: The Applicability of Agency Theory to Nonprofit Boards,” *Nonprofit Management and Leadership* 12, no. 4 (2002): 429-450.

3 Revised Model Nonprofit Corporation Act, Section 8.01; New York Not-for-Profit Corporation Law, Section 701 (“a corporation shall be managed by its board of directors”); California Corporations Code, Section 5210 (“the activities and affairs of a corporation shall be conducted and all corporate powers shall be exercised by or under the direction of the board”).

4 Ostrander, S.A. *Women of the Upper Class* (Philadelphia: Temple University Press, 1984); Ostrower, F. *Why the Wealthy Give: The Culture of Elite Philanthropy* (Princeton, NJ: Princeton University Press, 1995); Odendahl, T. *Charity Begins at Home: Generosity and Self-Interest Among the Philanthropic Elite* (New York: Basic Books, 1990).

5 Organizations generally maintain the confidentiality of their donors, but we are able to provide some examples on an anonymous basis.

6 Ostrower, *Why the Wealthy Give*.

7 Widmer, “Role Conflict, Role Ambiguity, and Role Overload on Boards of Directors of Nonprofit Human Service Organizations.”

8 Middleton, “Nonprofit Boards of Directors.”

9 Handy, F. “Reputation as Collateral: An Economic Analysis of the Role of Trustees of Nonprofits,” *Nonprofit and Voluntary Sector Quarterly* 24, no. 4 (1995): 295-305.

10 Ostrander, *Women of the Upper Class*, p. 134.

11 Bowen, W.G., *Inside the Boardroom* (New York: John Wiley & Sons, 1994); Oster, S.M. *Strategic Management for Nonprofit Organizations: Theory and Cases* (New York: Oxford University Press, 1995).

12 Yermack, D., “Higher Market Valuation of Companies with a Small Board of Directors,” *Journal of Financial Economics* 40, no. 2 (February 1996): 185-212.

13 Bowen, *Inside the Boardroom*.

14 Ostrower, *Why the Wealthy Give*.

15 Revised Model Nonprofit Corporation Act, Section 8.01(c).

16 California Corporation Code §§ 5210.



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